

# OSBD ISSUES

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## The Budget Reserve Trust Fund

### THE ISSUE

*Kentucky's financial outlook as we head into the next budget cycle mirrors the weakening fiscal condition of many other states. A recent report from the National Council of State Legislatures stated that 17 states grappled with budget shortfalls arising in FY01. Kentucky's economic and fiscal outlook are stable – but fiscal responsibility and caution are central themes we must focus on as the market continues to adjust, growth in revenue continues to decline, and consumer confidence continues to slip.*

### WHY WE TAPPED INTO THE FUND

No one likes to have to dip into his savings – yet that is precisely why the Commonwealth of Kentucky has a Budget Reserve Trust Fund. The savings account in this case is the Budget Reserve Trust Fund, also referred to as the Rainy Day Fund. In FY01 \$38.8 million was taken from the fund and \$120 million was tapped in FY02 as part of budget balancing measures. Kentucky is not alone in tapping its Budget Reserve Trust Fund. According to the same NCSL report mentioned previously, 10 states tapped into their rainy day or other reserve funds.

Without using the \$158.8 million from the fund, programs such as education would not have been able to have been exempted from budget cuts. The intent of rainy day funds is to sustain and salvage good programs which are already in place when bad times occur. These funds are meant to be long term strategic sources of reserve funds – funds that are only tapped in the event of major economic downturns. Rainy Day Funds do not take the place of budgetary discipline, rather they provide the time necessary to make reasoned choices.

Kentucky's General Fund growth began to slow noticeably in the fall of 2000. The sales and use tax, which should have grown rapidly in FY01 due to an expansion of the base, instead performed poorly and did not meet expectations. This had been masked due to rapidly rising individual income tax receipts, but as the economy suddenly began to decelerate, income taxes, both personal and corporate, joined the sales tax in failing to reach forecasted levels. By last winter, it became apparent that the General Fund was unlikely to reach the original forecasted level.

Kentucky is not alone in having to adjust to the revenue shortfall. The current fiscal year has several states besides Kentucky taking extraordinary steps to balance their budgets. Even the federal government is not immune, as projections of future sur-

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pluses are disappearing as the economic situation worsens.

### WHAT WE MUST DO AND WHY

The state is not in financial jeopardy – but the need to replenish the Rainy Day Fund in a timely manner is critical to the future fiscal health of the Commonwealth. A Rainy Day Fund helps reduce the interest the state pays on its bond issues. The bond rating companies are especially interested in how states manage their financial affairs, including how they handle future contingencies related to economic growth and recession or slowdowns in the economy. The bond rating companies look to see if there are revenue balances or reserves, which could be called upon in the event of revenue shortfalls. The ending general fund balance and a rainy day fund are the most common forms of available monies to meet an issuer's contingencies.

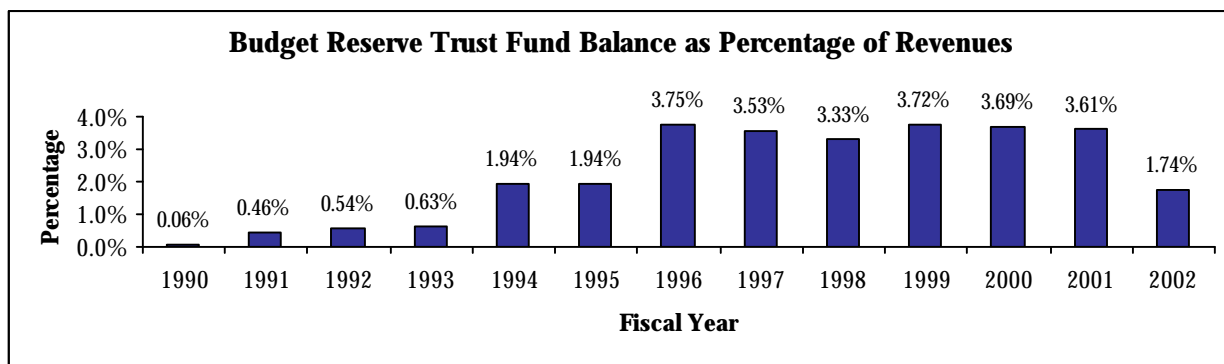
Bond rating agencies consider states with effective mechanisms for building financial reserves to be exhibiting fiscal discipline and preparedness for dealing with economic downturns. All but four states have established a rainy day fund, and the major bond rating agencies have all begun using this fund as an important criterion for assessing the credit worthiness of bond issues. If the Commonwealth's credit rating is reduced it could easily translate into an increase in the cost of debt service. As an example, a \$150 million bond issue potentially could cost the Commonwealth \$10+ million in additional interest payments over the term of the bond if interest rates increased by as little 1/2 percent. This is money that could be spent on other programs in the state. In addition, maintaining a sound budget reserve will be critical if federal entitlements are eliminated or reduced or if the state experiences a severe economic downturn.

The overall ratings of the fifty states' bond issues have remained virtually unchanged since the end of 1998. This is in spite of the highest general fund balances of the last 20 years, strong state income growth, and only a slight increase in per-capita debt levels. Some states, like Kentucky, have seen rating upgrades into the "AA" and "AAA" categories after the 1991 recession. The achievement of receiving an "AA" rating (June 1999) from all three agencies is an important development for Kentucky. Portfolio managers often require a bond issue to carry a rating of "AA" before they will consider adding the issue to their investors' portfolios. With this rating, bonds issued by the Commonwealth enjoy a greater market demand and provide lower costs of borrowing.

Kentucky has, by KRS 48.705, set a goal of maintaining a Budget Reserve Trust Fund (BRTF) balance of approximately five percent of annual General Fund revenues. Rating agencies, the National Conference of State Legislatures, and other states, acknowledge that a rainy day fund equal to five percent of the general fund budget is a prudent level to put aside for an economic downturn. As bond ratings have increased for Kentucky we enjoy lower interest rates.

Formally established in 1987, Kentucky's Budget Reserve Trust Fund increased by more than \$250 million after its inception. At its peak in FY2001, the BRTF carried a balance of \$278.6 million. Budget balancing measures in FY2001 and 2002 have taken a total of \$158.8 million from the fund leaving a balance of \$120 million or 1.74 percent of the General Fund. Attention must now be focused on rebuilding the fund.

## The Budget Reserve Trust Fund cont'd



Source: FY 1990-2000, Actual; Kentucky Financial Report; FY 2001, Office of State Budget Director;  
FY 2002, June 19, 2001 Consensus Forecast Group

Note: Revenues for FY 2000-2002 do not include tobacco receipts from the Master Settlement Agreement (MSA).

### HOW ARE WE PROPOSING TO REPLENISH THE FUND?

There are several methods by which the Budget Reserve Trust Fund can be replenished. A meaningful public policy option may require a combination of these alternatives. It is of utmost importance to the fiscal health of the Commonwealth that we create a mechanism for replenishment of this fund.

Alternatives for replenishing the Budget Reserve Trust Fund include the following:

- 1) Allocation of surplus funds as has been done in the past through the Surplus Expenditure Plan

One downside of this alternative is the uncertainty and unpredictability of surpluses.

- 2) Direct appropriation in one or both years of the biennium  
Bond rating companies have established a 5 percent guideline as an appropriate level for the BRTF and direct appropriation to move Kentucky toward this goal would demonstrate a strong commitment of Kentucky policy makers to this important financial management principle.
- 3) Allocation of lapsed debt service  
Earmarking these funds, which arise from surpluses realized through lower than projected interest rates, delay on capital construction projects, and interim short-term financing would provide a consistent allocation to the BRTF.
- 4) Allocation of investment income  
The Commonwealth could dedicate some portion of income earned on investment of state dollars to replenish the BRTF.
- 5) Borrowing  
The Commonwealth could make a firm commitment to replenish the fund by borrowing an appropriate amount and repaying it over time in the form of debt service payments.

There is no identifiable "right" solution but the Commonwealth must develop a credible

strategy to replenishing the Budget Reserve Trust Fund. For a comprehensive report on this issue please refer to Policy Paper Vol. 1 No. 1, *The Importance of State Rainy Day Funds*, available on our website [www.osbd.state.ky.us](http://www.osbd.state.ky.us) or you may contact Michael Jones (GOPR) at (502) 564-7300.

COMMONWEALTH OF KENTUCKY

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